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Observations on the Use of Law by Russian Enterprises

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Observations on the Use of Law by Russian Enterprises

Kathryn Hendley, Barry W. Ickes, Peter Murrell,
and Randi Ryterman¹

Abstract: Four specialists on the Russian economy analyze the extent to which enterprises use law and legal institutions in structuring exchange relations. The analysis uses the responses from questionnaires administered to sixty officials of fifteen enterprises in Moscow and Yekaterinburg during May-June 1996, supplemented by interviews in enterprises and within *arbitrazh* courts. Their results indicate that enterprises make little use of law and consider legal institutions to be *ineffective*. Other than ties based on historic business relations, there is an absence of social and economic networks that might function as substitutes for law. The underdevelopment of institutions to foster impersonal relations between firms shows restructuring and growth. *Journal of Economic Literature*, Classification Numbers: P51, P11, K1.

Market economies need institutions that are able to foster the development of impersonal relations between economic agents. Such institutions might be especially important for economies in transition, in which changing relationships are vital to enterprise restructuring and where whole sectors of the economy are the natural terrain of new firms. Among the set of requisite institutions are: (1) generally accepted rules that help to structure economic relationships; (2) mechanisms for enforcing agreements; and (3) procedures for dispute resolution. In this report, we present evidence on the extent to which Russian enterprises currently make use of such institutions.

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The article is based primarily on sixty interviews conducted within fifteen manufacturing enterprises in Yekaterinburg and Moscow during May-June 1996. We conducted detailed, structured interviews with four respondents in each enterprise: the general director, the director of supply, a subordinate of the director of supply, and the legal director.² The results reported here are based on a small number of observations on a large number of variables. The data, combined with extensive informal interviews in these and other enterprises, as well as in *arbitrazh* courts, present a consistent picture of the use of law and legal institutions by Russian enterprises.

We conclude that Russian enterprises make little use of law and legal institutions in structuring their relationships. Lawyers are usually peripheral actors in the enterprise. Formal contracts are used, but as a matter of routine rather than of strategy, the form of the contracts changing little in response to circumstance. All the enterprises interviewed had made use of the *arbitrazh* courts, but rated such courts very poor on enforcement.

The minor role of legal institutions holds important implications for Russian economic performance. First, a large proportion of transactions appears to be based on ties inherited from Soviet times.³ Second, firms are forced to rely on prepayment, often in combination with barter, as the preferred method to ensure that purchasers fulfill contracts. Such payment terms impose large transaction costs and do little to build confidence in the legal system. Third, semi-legal or illegal enforcement methods are common, with their associated social and economic costs. Fourth, there seems to be a dearth of complex transactions between enterprises—that is, transactions involving long-term agreements for the exchange of highly differentiated products. It is possible that many potential transactions simply do not take place, with adverse consequences for economic growth.

A basic theme running through much of the ensuing discussion is the inertia of enterprises in those activities that involve the use of law and legal institutions, despite the enormous institutional changes that have taken place. Old contractual practices and forms continue. Legal knowledge lags. The use of courts appears to be based on routine behaviors. The range of transactions appears highly constrained by historical circumstance. The existence of such inertia obviously has momentous consequences for deliberations on the workability of alternative strategies of legal reform.⁴ Our presentation of the evidence begins with an overview of enterprise officials' evaluations of Russian institutions, such evaluations being a key factor in determining the use of existing institutions. We then examine

²The supply departments (*odely snabzheniya*) are responsible for the procurement of material inputs.

³Widely cited statistics from enterprise surveys overstate the degree to which new relationships have been formed (see discussion below).

⁴On the importance of understanding the role of inertia in assessing the effects of legal and economic reforms, see Hendley (1992) and Murrell (1992).

whether the enterprises are equipped to use the legal system, by inquiring whether officials have access to pertinent information and to suitable technical expertise. Discussion then turns to a specific example of the use of law and legal institutions, where we assess whether contractual behavior is adjusting to the new institutional environment and whether enterprises avail themselves of new legal tools to solve pressing transactional problems. Thereafter, we continue the focus on transactions, examining the role played by the courts in dispute resolution and considering the role of alternative institutions in the transactional process. Next, we use enterprise officials' knowledge of law as a lens on whether they are using the law to structure economic relationships. The final empirical section offers evidence on the complementarity of legal and financial institutions, by considering the causes and consequences of the prevalence of barter. Concluding observations examine implications of the evidence, focusing on the way in which the poverty of the institutional environment constrains the profile of transactions undertaken by Russian enterprises.

ENTERPRISES' GENERAL EVALUATION OF POLICY AND INSTITUTIONS

An important factor determining the use of institutions is economic agents' evaluations of the quality of institutions. To elicit enterprise officials' general views on policy and institutions, we used questions drawn from analogous Western studies. For example, Borner, Brunetti, and Weier (1995) questioned entrepreneurs in twenty-eight countries concerning the predictability of overall policy and the credibility of government. We asked identical questions in Russia, aggregating answers to derive a score exactly analogous to those reported in Borner et al. (1995). Our Russian score is worse than that of two-thirds of the countries in their sample. It is equivalent to the level of Argentina, Mexico, and Colombia in the late 1980s, significantly better than that of Brazil or Venezuela, but much worse than in Chile, Turkey, Sri Lanka, and all the East Asian countries.

This general perception is reflected in the abysmally low evaluations that Russian enterprise officials gave to major institutions. When asked how much confidence they had in the state administration, the legal system, parliament, and the political system, respondents almost uniformly gave the lowest rankings.⁵ Similarly, enterprise officials judged

⁵This summary of the Russian responses uses comparable information from other countries. Answers to identical questions on confidence in institutions given by Canadian and British general publics are reported in Hastings and Hastings (1994, pp. 297-300). Responses by the US general public to almost identical questions are reported in Wood (1990, pp. 630-662).

honesty and ethical standards to be very low within these institutions.⁶ State administration and the police were regarded particularly poorly. Enterprise officials openly reported the view that a high level of corruption is present in local administrations and that organized crime influences government.

If these responses, the legal system performed slightly better than did other Russian institutions. For example, the judges of the *arbitrazh* court were deemed to have higher ethical standards than other professionals. At the very least, this sampling of opinions on Russian institutions would not lead one to conclude that the legal system itself presents the biggest problem in creating a workable institutional structure.

THE INTERNAL ORGANIZATION OF ENTERPRISES ON LEGAL MATTERS

To use the legal system, economic agents need access to pertinent information and to appropriate technical expertise. In Russia, all the enterprises we visited had in-house legal expertise which, in all but one case, took the form of a legal department inherited from the Soviet period. The legal departments have shrunk as a proportion of total employment since 1992, now averaging three people per enterprise. As in the past, not all these people necessarily have legal education; lawyers have no monopoly on the performance of legal tasks in Russia.⁷ Although the form persists, privatization has wrought fundamental changes in the work undertaken by these legal departments. In the past, much of their time was dominated by labor issues, which have now faded in importance. Their function has also changed. The blurred lines between the interests of workers and management that existed under the state enterprise form have now come into sharper relief, and the legal department's role is to defend management, not to help workers solve their problems.

Half of the enterprises surveyed have a legal relationship with outside lawyers, typically in connection with foreign activities. Only one enterprise had retained a Western law firm. This Moscow enterprise turned to a U.S.-based law firm for help in staving off an unwanted tender offer. After the crisis abated, the relationship collapsed due to the unexpectedly high legal fees charged for what the enterprise regarded as routine services.

⁶ Again, this summary of Russian responses is implicitly phrased in the context of answers to comparable questions in other countries. Answers by Canadian general publics to identical questions on honesty and ethical standards in institutions are reported in Hastings and Hastings (1994, p. 297).

⁷ Most European countries have narrowed the scope of activities that must be performed by lawyers through the creation of a network of administrative agencies staffed by non-lawyers capable of handling issues such as consumer complaints, wage disputes, child welfare, etc. Often these agencies have the power to resolve disputes, thereby reducing pressure on the courts. See, for example, Kritzer (1996) and Blankenburg and Rogowski (1980).

Hourly fees are not traditional in Russia and certainly the high rates that are commonplace in the United States are unheard of.

The legal departments have access to timely information about new statutes and regulations. All enterprises subscribed to the standard printed sources.⁸ Seventy-five percent subscribed to computerized databases of legal information that are updated regularly. The most popular database was *Konsultant Plus*, which is the cheapest of the current crop of legal databases and focuses almost exclusively on business law information. Interestingly, we found that firms possessing legal databases demonstrated no more accurate knowledge of the law than did firms lacking this resource.

The willingness of enterprise management to purchase a database indicates that they attach importance to maintaining up-to-date knowledge about law. Yet, despite the fact that the legal departments serve as the main conduit for information about laws and legal institutions, these departments are not well integrated into the business life of the enterprises. One Yekaterinburg *arbitrazh* court judge, frustrated by repeated efforts to convey new information to enterprises via their lawyers, has begun ordering the general directors of these enterprises to appear in person in her court.

Representatives of the legal department do not regularly advise management about the consequences of proposed actions. For example, in one enterprise where issues of intellectual property were critical to survival, the legal department had not been consulted. These lawyers were neither surprised nor annoyed at being left out; they acknowledged that they lacked the necessary expertise, while admitting no plans to acquire the knowledge. Lawyers, whether in-house or external, do not play an active role in negotiating new contracts or restructuring existing business relationships. Nor are they typically involved in the details of internal corporate governance. Instead, their functions are more technical, such as producing standard form contracts or verifying the legality of contracts negotiated by others. In the enterprises we visited, the legal department represented the enterprise in *arbitrazh* court. But such participation by lawyers is not required. Interviews with *arbitrazh* court judges reveal that less than half the cases filed in these courts involve lawyers.

THE UNIMPORTANCE OF LEGAL STRATEGIES

The information presented above is ambiguous. Enterprise officials are negative in general about the quality of institutions, but least negative about the legal system. Enterprises have legal departments and have access to legal information, but legal expertise is close to the periphery of enterprise operations. To help to resolve the ambiguity in the evidence, our survey asked general directors to indicate the relative importance of four

⁸ Enterprises consistently subscribed to *Rossiyskaya gazeta*, *Sobremennye zakonomoditel'stven Rossiyskoy Federatsii*, and *Ekonomika i zhizn'*.

strategies to the survival of the firm: (1) internal reorganization; (2) restructuring trading relationships; (3) using laws and legal institutions to protect the firm's interests; and (4) delaying payments. Of these four, the use of laws and legal institutions scored the lowest, even below the delaying of payments—a strategy that is, in the Russian context, almost the antithesis of using law.

The absence of any positive strategy to make use of new legal opportunities is best exhibited by contractual behavior. Enterprise officials view written contracts as essential, and use standard form contracts for routine acquisition of supplies and for sales. The use of form contracts does not distinguish Russia from other countries. What is striking about Russian enterprises is their failure to take full advantage of the freedom of contract offered by the new civil code. During the Soviet period, the text of contracts was dictated from above. Changes were possible, but only by using the cumbersome "*protokol* of disagreements," in which the parties proposed alternative wording for contractual provisions. The final agreement was composed of the standard text plus any *protokoly*. Now, with firms having complete freedom, they still cling to the old Soviet mechanisms. When asked why the enterprise lawyers reacted with surprise, and told us that they continued to do their job in the same way as before. Upon reflection, they uniformly agreed that the old techniques (using *protokoly* of disagreements) constituted barriers to simplicity and clarity. Additionally, the form invariably originated with the supplier, as in Soviet times. Even powerful enterprises with considerable market power are reluctant to move away from past practice.

Many elements of contracts are not implemented. For example, with working capital very scarce and many enterprises insisting on prepayment, the terms of the contract do not control the behavior of the parties. Rather, when enterprises insist on prepayment, trading begins where funds become available: the quantity and timing clauses of contracts are irrelevant. Similarly, prices are set in contracts, only to be renegotiated. It is routine for suppliers to demand a higher price, with customers then either walking away from the contract or agreeing to pay if the demand is consistent with perceptions of changes in supplier costs. Court action for breach usually is not contemplated under such circumstances. Similarly, penalty clauses for delayed payment are routinely disregarded, and perhaps are included only as a bargaining tool.

We found little evidence that contracts are being used innovatively to help solve problems of non-payment and non-performance. Letters of credit, collateral, and other legal means of ensuring performance are rarely used. Instead, enterprises use devices that appear more costly, such as barter and prepayment. Of the 25 agreements on which detailed data were obtained, only two were free of both barter and prepayment. Ten had full prepayment; seven included partial prepayment; and of the eight with no prepayment, six were barter contracts. General directors report that, on average, they require customers to prepay 56 percent of their purchases, an amount that the enterprise directors assess as roughly equivalent to the cost of material inputs needed to produce the order.

LEGAL INSTITUTIONS AND THEIR SUBSTITUTES

The use of formal legal institutions is dependent, *inter alia*, on the effectiveness of those institutions, especially compared to substitute mechanisms. Here, we examine pertinent evidence on effectiveness, focusing on the role of institutions in supporting relationships between economic entities and resolving disputes that might arise in those relationships.

The Arbitrazh Courts

Arbitrazh courts have jurisdiction over economic disputes between legal entities and over bankruptcy. They are the institutional successor to Soviet-era state arbitrazh (*gosudarstvenny arbitrazh* or *gosarbitrazh*), which was an administrative agency charged with resolving economic disputes among state enterprises (Pomorski, 1977). On a superficial level, the two institutions seem similar in that they share the basic function of resolving disputes. As we probe more deeply, however, the differences become apparent. Most obvious is the matter of status. *Gosarbitrazh* has been transformed into a court system, complete with judges, multiple-level appellate review, and a new set of procedural rules (Arbitrazhnyy, 1995). Perhaps more important is the difference in purpose. As an embedded element within the administrative-command system, *gosarbitrazh* was concerned primarily with plan fulfillment. Complying with the law was desirable, but not mandatory. In contrast, the *arbitrazh* courts have no latitude to depart from the law in resolving disputes. Concern with the potential impact of their decisions is not supposed to infect the reasoning process.⁹

Some Western scholars argue that the *arbitrazh* courts are irrelevant to our data, albeit limited, suggest taking a more nuanced approach to the role of these courts. All of the enterprises we visited had interacted with the *arbitrazh* courts over the past year. Three-fourths of the enterprises had initiated more than four cases during this time.¹⁰ Of course, we cannot make conclusions about the regularity with which disputes or potential disputes reached the courts, not knowing the number of disputes that were resolved through bilateral negotiations (Felshtiner et al., 1980–1981). But the fact that every enterprise pursued claims to the *arbitrazh* court

⁹Despite this rule against considering how a decision might affect the parties, memoirs by judges in various societies indicate that their prior life experiences inevitably affect case outcomes (Uic, 1972; Satter, 1990).

¹⁰The drafters of the new Russian company law viewed the *arbitrazh* courts as weak, incompetent, and corrupt, and so designed a corporate law regime that, to the extent possible, substitutes private enforcement for formal judicial enforcement (Black and Krakman, 1996).

¹¹The survey asked only whether enterprises had filed more than four. Conversations with the lawyers at these enterprises revealed more detail. One firm was quite active, having initiated in excess of 100 cases over the past year.

certainly implies that management views these courts as potentially useful.

In our sample of enterprises, the most common reason for going to court was to collect overdue debts, though they also sued on the grounds of late delivery, damaged goods, and poor quality.¹² Unpublished data from the *arbitrazh* courts in Yekaterinburg and Moscow show that, as a general matter, debt collector cases predominate. In Yekaterinburg, debt-related cases constituted 74 percent of the total cases filed in 1995 (up from 38 percent in 1993). In the Moscow City *arbitrazh* courts, they constituted 60 percent of the total cases filed in 1995 (up from 35 percent in 1993).

As is true elsewhere, Russian enterprises rarely bring a lawsuit without it first notifying the party in default, and trying to settle the case. Indeed, prior to July 1995, plaintiffs were legally required to send a notification (*pretenziya*) to potential defendants prior to filing a claim in an *arbitrazh* court. Failure to do so resulted in automatic rejection of the petition.¹³ Notwithstanding the fact that *pretenziya* are no longer mandatory, many enterprises still use them. Some enterprises have not even bothered to change the format, while others have restyled the *pretenziya* to better meet their needs. In some cases, the text incorporates a threat to pursue the matter in *arbitrazh* court if the defaulter fails to perform, in other cases the threat is merely implicit.

Enterprise officials were asked several questions designed to elicit information about the qualities of the *arbitrazh* courts as dispute resolution mechanisms, especially in comparison to the predecessor institution, *gosarbitrazh*, and the prime competitor, private methods, the latter including private arbitration and private security services. Enterprise lawyers rated *arbitrazh* superior to *gosarbitrazh* on speed, competence, cost and confidentiality, but as very much worse on certainty of enforcement.¹⁴ Enterprises view enforcement problems as the most serious shortcoming of the *arbitrazh* courts. In a 1996 interview, the Chairman of the Higher *Arbitrazh* Court, V. F. Yakovlev, admitted that the inability to enforce judgments has become all too common (Vasil'yeva, 1996). Nevertheless, a number of enterprise officials noted that the parties in *arbitrazh* court sometimes comply with judgments, without any need for further court action. Court decisions can stimulate attempts to resolve disputes through negotiation.¹⁵

¹² Debt collection cases are common in Western legal systems as well; see Kagan (1984) and Blausenburg (1996).

¹³ The plaintiff would be free to refile the complaint after having fulfilled the procedural prerequisite.

¹⁴ See Hendley (1997) for a description of contract enforcement procedures in Russian *arbitrazh* courts. For a discussion of the persistent problems with enforcement, see Pistor (1996) and Vasil'yeva (1996).

¹⁵ In contrast, the threat of bankruptcy provides little inducement for performance; only a minority of respondents were aware of firms that have initiated bankruptcy proceedings, an observation consistent with economy wide bankruptcy data.

Problems of enforcement do not arise solely from the institutional structure of the court system. These problems also stem from the turbulent organizational structure of Russian business, with enterprises forming and dissolving, incurring and then escaping, liabilities. In the past, the banks were a powerful element of the enforcement mechanism, since a court judgment constitutes an order to transfer funds between enterprises. However, with relaxation of the banking laws, it is now much easier for enterprises to empty company accounts. While the law gives judges the discretion to freeze the assets of defendants at any point in the proceedings (Arbitrazhnyy, 1995), such orders in fact prove to be the exception, not the rule.

Enterprises also identified costs as a barrier to using the *arbitrazh* courts, though no enterprise reported an instance in which cost actually precluded filing a case. Interestingly, filing fees (*gosposhlina*) have actually been reduced in recent years. The concern expressed by enterprises about costs may, therefore, indicate a heightened concern about expenses of any sort.

The competence of the *arbitrazh* judges to resolve commercial disputes was not cited as an obstacle to using courts. Judges were generally viewed as impartial in cases involving other firms. However, several managers noted that jurisdiction is generally based on the location of the seller, and expressed concern that the *arbitrazh* courts take local interests into account when rendering verdicts. Managers clearly anticipated bias in cases in which the government is a party. The enterprises assume a high level of bias in cases involving the federal government and slightly less bias when local governments are involved. These perceptions might be inherited from Soviet times, when courts were not independent, or they might reflect real problems in the present organization of the *arbitrazh* courts.

Studies of other legal systems have shown that contractual partners who have a longstanding relationship are reluctant to pursue disputes in court. Going to court, it is argued, tends to destroy the relationship because it pits the parties against one another in a zero-sum game (Macaulay, 1963). Our information suggests that Russian enterprises do not perceive court action in such dire terms. Several general directors reported instances in which relationships survived lawsuits. The lawyers were somewhat less sanguine, regarding lawsuits as something to be avoided because of the danger of offending suppliers. Perhaps the absence of an adversarial legal system and the lower costs of pursuing legal claims help explain why the impact of lawsuits is less devastating in the Russian context.

Private Methods of Contract Enforcement

General directors rated private methods as superior to *arbitrazh* courts on speed and confidentiality. It is notable, however, that private methods were not viewed as superior to *arbitrazh* on certainty of enforcement, despite the inadequate enforcement mechanisms noted above.

The prevailing private methods of contract enforcement or dispute resolution are semi-legal or illegal. The enterprises interviewed do not use

formal, legal private methods of dispute resolution, such as private arbitration.¹⁶ Enterprises use security services to collect debts. For some enterprises, this is routine and there are standardized procedures for hiring outside help in cases of non-payment; one estimate of the cost was twenty percent. Enterprises make even more use of internal private security services than they do of outside security services. The use of internal security services is negatively correlated with enterprises' evaluation of *arbitrazh* courts, indicating that the courts and private methods might be substitute methods of dispute resolution. However, formal legal institutions and private enforcement can also be complements. Private enforcers often review relevant legal documentation before acting. When a losing defendant fails to pay according to the terms of an *arbitrazh* court decision and the victorious plaintiff seeks the assistance of private enforcement agents, these agents sometimes review the court decision before taking action.

The Role of Government

In examining the role of government, our focus was on activities of the administration that would either support or impede the development of enterprise-to-enterprise relationships. Our questions centered on the involvement of local and national administrations in the more commonplace aspects of enterprise operations, such as the setting of prices, the search for customers, and the choice of products to be produced. Enterprises reported surprisingly little administrative activity on these matters. Similarly, local and national administrations were viewed as uninvolved in the process of negotiating agreements, and settling disputes, with suppliers, at least in the perceptions of the enterprise officials who procure the standard menu of inputs.

Administrative bodies are not active in areas where they might be expected to use a positive force in facilitating more secure trading relationships. When enterprises were asked why they had not used legal instruments such as collateral, they tended to attach importance to the inadequacy of associated administrative arrangements, such as registries. In addition, the poor functioning of criminal law enforcement bodies might be critical, since fraud and forgery were cited as important problems in using legal documents such as letters of credit.

Early in the transition, enterprises were very concerned about problems of market power. In 1991, the federal government responded to these complaints by establishing anti-monopoly committees, which were empowered to sanction enterprises that engaged in unfair competition.

¹⁶One form of private arbitration that has long existed in Russia are *trudovye* courts (Kallistratova, 1993; Vinogradova, 1993). The enterprise managers we interviewed were typically not aware of such courts. Pistor (1996) documents the activities of *trudovye* courts in Moscow and St. Petersburg; whether these courts are active in Yekaterinburg remains open to question.

None of the sampled enterprises reported that they had been subject to actions by anti-monopoly committees, and most were unaware of sanctions against other enterprises. Even the officials of enterprises that had been classified as "dominant" producers knew little about the activities of the local Anti-Monopoly Committees. All of which suggests that these committees do not play an important economic role.

Social and Economic Institutions

Enterprises were asked about the importance of a variety of ancillary interrelationships that might support the development of secure trading relationships. In market economies, there are many social and economic institutions, outside the legal and administrative systems, that help foster the development of new economic relationships and aid in dispute resolution. For example, in the economic sphere, there is cross-ownership between supplier and customer; in the social sphere, there are ethnic and family ties as well as personal contacts that develop in clubs and social activities.

Enterprise officials rarely reported the existence of economic relationships that complement the trading relationship. Trading partners do not tend to share banks, or have common membership in business associations, or share members of boards of directors. A small amount of cross-ownership of shares between trading partners was reported.

Enterprise officials were also asked about professional, ethnic, family, educational, social, and political relationships, developed apart from business dealings, but which might have been helpful in forming trading relationships and resolving potential disputes. Virtually none of these suggestions produced any resonance with our interviewees. The absence of a civil society in the past, with lives being centered on enterprise and party-organized activities, could be exerting a toll presently in the underdevelopment of new market relationships.¹⁷

Two types of special relationships were cited as helping in present trading relationships. First, enterprise officials mentioned previous contacts through institutions of higher education. The examples given were usually ones in which an enterprise official knew a counterpart in another enterprise because they both had attended the same technical institute, usually an institute run in Soviet times by the enterprise's sectoral ministry. This suggests that the narrow specialization present in the Soviet educational system might now be leading to a narrowness of contacts between enterprises.

Second, enterprise officials reported that horizontal connections with comparable officials in other enterprises helped in resolving disputes. When problems arise in trading relationships, sales and procurement

¹⁷Enterprise general directors invariably reported membership in the Communist Party in the Soviet period, but such common membership appears not to have been important at the detailed level of trading relationships.

officials will use a counterpart in a third enterprise as a source of information and as an instrument of pressure on the trading partner. Such chains of acquaintance, of course, are usually based on supply links established in Soviet times.

KNOWLEDGE OF LAW

Use of the law is unlike the use of a material input, whose employment can be directly measured, compared to the role of substitutes, and calibrated against likely causal variables. Therefore, it is necessary to examine variables that are indirect indicators of the use of the law. One such variable is accuracy of knowledge of the law (see Ellickson, 1991). Managers who use law on a regular basis, who work in enterprises in which using law is an important part of the business routine, will tend to have a better understanding of law than managers who never use law. Given that many laws in Russia are new, we examine the managers' knowledge of only the most basic aspects of statutes, arguing that these aspects should be well known to managers with even limited contact with the law.

Use of the law influences knowledge, but knowledge also influences use of the law. A manager's understanding of law affects perceptions of the law's usefulness for solving important economic problems. A manager who is misinformed about basic provisions is unlikely to recognize those circumstances where law has a potential to solve economic problems.¹⁸ Hence, an understanding of basic provisions of laws is a necessary (although not sufficient) condition for using law. For example, a manager who possesses complete and accurate information about the law, but whose experiences lead him to conclude that pursuing legal remedies is inefficient, may choose not to use the law.

To measure knowledge, we posed a number of questions to enterprise officials. The questions were framed either directly, in terms of knowledge of basic legal provisions, or indirectly, using hypotheticals that asked the official to interpret the law within a specific context.¹⁹ Our questions focused on areas of law that address serious problems faced by managers—problems that are of special consequence in a transition environment characterized by uncertainty and the need for restructuring. We concentrated on four areas of law: secured lending, contracts, competition, and internal governance.

Law on Secured Lending

One of the most serious and persistent problems in Russia is non-payment. All enterprises complained about the inability of many of their customers to provide payment in full on a timely basis, in nearly all cases,

¹⁸This is particularly true when the legal department is not well integrated into the decisionmaking process of enterprises, as is the case in Russia.

¹⁹We asked managers to answer our questions without using reference materials, to ensure that we were measuring knowledge that is used on a routine basis.

enterprises admitted that they faced difficulties in meeting their own obligations. Yet, despite the persistence of these problems, we found little understanding of laws designed to alleviate such problems.

Collateral is a potentially important mechanism for securing agreements. However, only about one-half of enterprise lawyers knew that, according to the 1995 Civil Code, pledges of moveable assets do not have to be notarized; their responses, in short, were consistent with random guessing.²⁰ Hence, the lawyers appear unaware that their enterprises can secure agreements without incurring the often substantial fee associated with notarizing. In addition, only 50 percent of enterprise lawyers knew that the creditor who secured the loan at the earlier date has priority claim to an asset that has been used to secure two loans (Grazhdanskii kodeks, 1994, art. 342).

Most importantly, enterprise officials are not aware of the fact that the 1995 Civil Code assigns secured creditors priority over the government in claiming the assets of a liquidated company (Grazhdanskii kodeks, 1994, art. 64).²¹ As shown in Table 1, only eight percent of general directors and nine percent of legal directors correctly identified the secured creditor as having priority. Three-quarters of general directors and almost two-thirds of legal directors identified the government as having first claim. These responses were less accurate than those that would be obtained simply from random guesses. The reason seems clear. Managers appear to be echoing the priorities assigned by the 1964 Civil Code (Grazhdanskii kodeks, 1964, arts. 418–423), which is now defunct. With this understanding of the law, collateral is not likely to be seen as a useful instrument, given the common perception that the indebtedness of debtors to the government often exceeds liquidated value.

Contract Law

During Russia's transition from a command economy, economic conditions have changed unexpectedly, often placing hardship on one of the parties to an agreement, making that party reluctant to perform as promised. Questions naturally arise concerning the circumstances under which changing conditions or hardship might constitute an excuse for non-performance (Hendley, 1996). The 1964 Civil Code (Grazhdanskii kodeks, 1964, arts. 169, 222, 234–235) accepted only literal impossibility, i.e., acts of God, as providing such an excuse. The 1995 Civil Code, by contrast, expands the definition of impossibility to include commercial

²⁰The first part of the civil code (Grazhdanskii kodeks, 1994) became effective on January 1, 1995. An English translation can be found in Civil Code (.995). The second part of the civil code (Grazhdanskii kodeks, 1996) was enacted on December 22, 1995, and became effective on March 1, 1996.

²¹The 1992 Bankruptcy Law ranked the claim of secured creditors above the claim of the government, giving even higher priority to secured creditors than does the 1995 Civil Code (O nesostoyatel'nosti, 1993).

Table 1. Enterprise Officials' Understandings of the Priority of Creditors: Consistency with Old and New Civil Codes.

Creditor with priority according to:	Percent of responses consistent	
	General Director	Legal Director
1995 Civil Code: secured creditor	8 percent	9 percent
1964 Civil Code: government	75 percent	64 percent

impracticability due to a change in conditions that could not reasonably have been foreseen at the time of concluding the contract (Grazhdanskiy kodeks, 1994, art. 451). This change in the law might have been interpreted to allow parties to invalidate contracts on the basis of changes in input prices, but the new law has been interpreted rather conservatively. Changes in input price (even during the period of rapid inflation) were considered to be foreseeable by the parties and, therefore, could not serve as a basis for being excused from performance. Thus, the 1964 and 1995 Civil Codes are consistent in not accepting a change in price as an excuse for non-performance.

We questioned enterprise officials on whether foreseeable changes in input prices constitute an excuse for non-performance. Supply directors and their subordinates consistently, and correctly, answered that foreseeable changes do not provide an excuse. In practice, however, enterprises either accommodate price changes associated with cost increases or let the contract fall into abeyance. In this case, apparently knowledge of the law does not translate into use of the law against non-performing partners. The accuracy of the answers in this case could be because the enterprise officials simply assume that current law is consistent with that in the past.

Anti-Monopoly Law

We questioned officials concerning their understanding of competition law (O konkurentstii, 1991; O vnesenii, 1995). The officials were aware of the existence and purpose of this law. For example, nearly all general directors understood that they have the right to file claims against dominant producers when harmed and have the right to challenge the decisions of Anti Monopoly Committees in court. However, officials were less clear about basic provisions of the law pertinent to enterprises and local governments and about the powers awarded to Anti-Monopoly Committees to restrain anti-competitive behavior. Table 2 summarizes some notable features of the results of the questions on these basic provisions.

Table 2 presents a mixed picture. In two cases, managers scored only slightly better than they would have simply by random chance. In the remaining cases, the managers scored substantially worse than they

Table 2. Knowledge of 1991 Anti-Monopoly Law, Amended in 1995

Provision of the law	Respondent	Percent correct
Illegality of price fixing	General Director	33
Legality of speculation	General Director	33
What is an abuse of power by firms with dominant position?	Legal Director	65
Existence of restraints on activities of local governments	Legal Director	68
Absence of Anti-Monopoly Committees' powers to control prices of dominant producers	Legal Director	9

would have by random chance. In these latter cases, the origin of the misunderstanding might be rooted in history. The pervasive use and acceptance of price controls in the past might account for the fact that only one-third of managers correctly understand that price fixing is illegal.²² It also might account for the fact that only nine percent of managers are aware that Anti-Monopoly Committees are forbidden to use price controls as sanctions against dominant producers. Perhaps most surprising is the persistence of belief that "speculation" is illegal, despite the fact that freedom of exchange is the cornerstone of market reforms. On matters of price controls and price fixing, our results on knowledge suggest that a necessary condition for the effectiveness of law is not being satisfied.

Company Law

The new Russian company law (Ob aktsionernyykh, 1996) provides measures aimed at improving corporate governance.²³ Yet, despite the fact that this law mandates actions by enterprises, basic aspects of the law do not appear to be well understood. For example, fewer than half of the enterprise officials understand that the general director must obtain either board-of-director or shareholder approval for transactions that involve more than 25 percent of the firm's assets. While nearly all of the enterprise lawyers understood that the general director can process routine contracts, a majority did not understand that the general director alone might not be able to process contracts that are not routine. Enter-

²²When two firms together control 66 percent of the market.

²³The law was passed in late 1995 and became effective on the first day of 1996.

prise lawyers did understand, however, that the general director can no longer simultaneously serve as chairman of the board of directors.

In fact, officials openly reveal information that shows that their enterprises are not in compliance with the company law. Only one-third of the firms that are required to keep their shareholder registers outside the firm actually do so. Of the five firms in our sample that are required to use cumulative voting to elect Board members, only one has done so (Ob aksionernyykh, 1996, art. 66-1).²¹

In sum, we found that enterprise officials in Moscow and Yekaterinburg had relatively accurate knowledge of those provisions of laws that are consistent with prior practices or with old legislation. However, the officials were poorly informed on those aspects of legislation that depart from prior practice. These results on legal knowledge suggest the paradoxical conclusion that the law that is most effective in the transition might be the law that is inherited.

BARTER: THE COMPLEMENTARITY OF LEGAL AND FINANCIAL ARRANGEMENTS

Barter is now an extremely important element in transactions between enterprises in Russia. In every enterprise in our sample, respondents testified that barter as a share of total sales had increased significantly since 1992. According to general directors, the average share of barter in sales was 40 percent in 1996 compared with 5 percent in 1992.²² The comparison with 1992 is interesting, because the financial system was much more underdeveloped then, and inter-enterprise arrears as a share of output were much higher than at present.²³ The fact that the frequency of barter has increased in spite of development of the financial and legal systems is a phenomenon that demands explanation.

Respondents recognized that barter is very costly: one estimated that barter entails a 100 percent surcharge over the cost of paying in cash. The costs of barter include the standard problem of finding mutually beneficial trades.²⁴ This problem is somewhat mitigated, however, by the fact that

²¹ This provision applies only to joint-stock companies with more than 1,000 shareholders; see Gordon (1994) for a description of cumulative voting.

²² Also, supply directors and their assistants were asked for their estimate of barter as a share of material supply purchases. The heads of supply departments reported an average of 48 percent in 1996 and 19.7 percent in 1992. Their assistants reported an average of 48 percent in 1996 and 18.2 percent in 1992. A January 1996 survey of 1,670 industrial enterprises in Russia revealed that 42 percent of their trade is through non-monetary exchange, including barter and various types of commercial paper (Mikharinov, 1996, p. 17). See Lakes and Bytnerman (1992) for a discussion of financial underdevelopment and inter-enterprise arrears.

²³ One respondent offered the following example: "You send the goods to an enterprise and they send you motorcycles. You don't need motorcycles, so you send them back and they send you wheat. Then you have to process the wheat. By the time this is done it is three months."

much of the barter we observed turns out to be multilateral, which expands the scope for mutually beneficial exchange.²⁵ It also makes transactions much more complex.

Multilateral barter introduces elements into transactions that tend to reduce the effectiveness of normal contract-enforcement mechanisms. With bilateral barter, a *quid pro quo* exists, and it is feasible, in principle, to write a contract specifying the transaction. With multilateral barter, trade is sequential rather than simultaneous. This has two important effects. First, the absence of a *quid pro quo* in any particular exchange makes the writing of contracts extremely difficult. Second, the sequential nature of trade increases the chances of hold-up. Both effects make such transactions more dependent on extra-legal contract enforcement mechanisms, which has the effect of conserving existing ties.²⁶

The prevalence of multilateral barter has important implications for the effectiveness of the legal system. *Arbitrazh* courts rely almost exclusively on written evidence. If a barter transaction goes through several parties, then much will be left undocumented and will rest on oral understandings. Thus, the sort of proof necessary to recover in *arbitrazh* court is absent, leaving firms to resolve problems through extra-legal means. *Arbitrazh* judges report that they are rarely confronted with cases involving multilateral barter arrangements.

A full accounting of the reasons why barter is now so prevalent would require a lengthy study of its own. Enterprises offered different reasons and individual respondents were often not consistent in their articulation of these reasons. Certainly, no single cause is responsible for this barter epidemic which results from a complex web of institutional inadequacies. It is nonetheless important here to distinguish between two commonly cited explanations for the prevalence of barter: the liquidity and the tax explanations.

Respondents frequently referred to a lack of working capital or exorbitant interest rates, or "a lack of means of payment."²⁷ These observations are consistent with the fact that financial stabilization has led to increases in real interest rates. On this liquidity explanation, barter is simply a response to a lack of means of payment.

The liquidity explanation, however, is not consistent with the fact that sellers who are offered cash often suggest barter, a common finding in our interviews. If lack of liquidity were the primary explanation for barter, we would expect that enterprises searching for material inputs would be the instigators of barter transactions. Sellers would prefer to receive monetary payment rather than payment in kind. The fact that sellers often

²⁵ This has also led to the rise of intermediaries that exist simply to guarantee complicated barter transactions.

²⁶ Multilateral barter often follows the chain of production. Trust seems to play an important role, thus making barter relationships highly dependent on historical ties.

²⁷ One respondent said he would cease barter if annual interest rates decreased from over 100 percent to 40 percent.

prefer barter indicates that there are advantages to barter that arise from factors other than the desire to conserve scarce liquidity.

The second common explanation offered by enterprise officials is that barter enables them to avoid tax payments or to reduce tax liabilities. Because federal banking laws force enterprises to channel inter-enterprise payments through the banking system and because banks can be forced to forward to the government funds of enterprises with tax arrears, enterprises often have a very strong incentive to keep their resources out of the banking system. Hence, barter is a way to delay the payment of previously incurred tax liabilities. The use of banks to facilitate tax collection, which might be efficient under normal circumstances, apparently leads to dysfunctional barter activity when this arrangement is combined with an enterprise system that has heavy tax arrears.

A key question about the tax explanation of barter is whether barter can also help reduce liabilities. Tax authorities certainly attempt to value barter transactions so that taxes can be assessed. However, in the multilateral case, it is difficult to discern what is received in a transaction. When enterprise A delivers output to enterprise B and receives goods from C, the goods from enterprise C are really revenue for A, but it is possible for A to claim that these are new purchases. Complexity thus makes it more difficult for the authorities to unravel transactions.³¹

Often these multilateral barter transactions include securities. An interesting form is IOU's to large utilities such as *Gazprom*. These IOU's might be superior to barter or cash, within the present chaotic institutional environment, with enterprises desperate for sales of any type. An enterprise delivers some output to *Gazprom*, but obtains IOU's from other enterprises, rather than cash, as means of payment. This allows the enterprise to avoid paying taxes immediately on the sale, and to use the IOU's to barter for inputs with other enterprises. Transacting using these IOU's is less costly than simple barter because the IOU's function as a money substitute. And yet the fact that the IOU's are not money is advantageous for the enterprises. Unlike money transferred *via* banks, the IOU's cannot be easily confiscated as payment for tax arrears and, given the present accounting system, the IOU's are not necessarily entered into the books of enterprises as revenues.

³¹In addition, the profit-tax rules, as implemented, were reported to provide an incentive for such transactions, by allowing firms to treat payables and receivables asymmetrically in the calculation of taxable income. Naturally, firms operating on a cash basis are allowed to defer recording receivables as revenue until actual payments are received. But, apparently, they are also allowed to record payables as expenditures as they accrue, deducting them from revenues. In this case, firms can reduce their tax burden, for example, by reorganizing a bilateral barter transaction into two separate monetary transactions, in which each firm "purchases" the goods of the other, using promissory notes they never intend to honor. This method of tax avoidance is more difficult to detect when the transaction is multilateral.

Multilateral barter thus offers an example of the deep complementarity among institutions. Because overdue taxes are collected upon receipt, enterprises have an incentive to use payment methods that avoid banks. But such payment methods make it harder for courts to enforce judgments because there are no funds in the accounts of enterprises. This reduces the incentives of parties to use the judicial system, forcing enterprises to develop alternative, more costly, means of contract enforcement.

An overall evaluation of the cost of barter depends crucially on which explanation of the existence of barter is correct. If barter is a response to tight credit, then enterprises that are least liquid must resort to the higher-cost transactional alternative, barter. Given the poor institutional structure, this might be efficient. However, this reasoning does point to the large benefits that could be gained from institutional development. Alternatively, if barter is primarily a consequence of the tax system, then its use is more damaging. The attempt to avoid taxes leads enterprises to resort to inefficient transactional modes, which are highly dependent on historical relationships and which reduce the possibility that law and legal institutions can play a constructive role in facilitating transactions and dispute resolution.

CONCLUDING OBSERVATIONS

Little in the evidence presented above would lead us to conclude that Russian firms are making a positive effort to use law and legal institutions in structuring their relationships with other firms. Where the use of legal forms or legal institutions is relatively common, as in the employment of written contracts or of the courts, the behavior seems to be as much the result of routine as of conscious effort to change.

The absence of strategies to restructure relationships using legal instruments cannot be explained by the presence of strategies based on alternative institutions. We found little evidence of networks arising in the economic, political, or social spheres that help in resolving disputes or enforcing agreements. The only exception was business ties developed during the Soviet era. But such ties fail to provide firms with what they need most to restructure: a means to secure agreements with firms with which they have had no previous interactions.³²

Given the circumstances, it is hardly surprising that a large proportion of the exchange relationships described to us in interviews were based on historic ties. This was initially unexpected, however, since recent enterprise studies are fond of citing statistics that imply that contracting based on impersonal relations is not a problem in Russia. These statistics suggest that a large share of enterprise relationships are new. During our interviews, we discovered that these statistics almost certainly overstate the

³²For an analysis of the conserving effect of historic networks on the incentive to restructure, see Ickes, Kylerman, and Teney (1995).

incidence of new relationships. When we asked officials in supply department to state the share of relationships that were formed after the breakup of the Soviet Union, they often cited figures close to 80 percent. However, on further inquiry, we discovered that many of these new relationships are changes of form, not of substance.³⁴ As expressed by one supply official, "The firms change, but the people remain the same."

It is important to note that the reliance on historic ties does not result from a perception of a lack of alternatives. In contrast to the early years of reforms, enterprises are now aware of the existence of competitors in the market.³⁵ We found no evidence of the perception of a high degree of mutual dependence among trading partners. In the enterprises interviewed, no monopolistic or duopsonistic relations were reported in highly dependent on them: in a sample of 25 supply agreements, none of the reporting firms considered itself to be a monopolist and only one considered itself to be a duopsonist.

Some firms are able to adjust to the failure of the legal and financial systems by changing organizational boundaries. For example, firms that supply the consumer market reported that they are expanding their operations into retail outlets to increase the reliability of payments. Some profitable firms have informally become "banks," using information received during trading. These firms forgo prepayment from reliable customers, while prepaying reliable suppliers. In contrast, the same firms insist that newer, smaller customers prepay, while refusing to prepay newer, smaller suppliers.

We also observed organizational innovation to facilitate transactions. Some enterprises now trade with intermediaries whose origins often lie in the former state trading system. These "new" intermediaries are providing services that were not provided previously. They facilitate transactions by accepting risk or providing credit. They sell goods without requiring prepayment. They might arrange multilateral barter transactions or facilitate customs transactions. Yet the owners, managers, and workers of these intermediaries are typically individuals who have historically been part of the trading network, and are now using their relationships with the management of manufacturing enterprises. But because the primary capital of the intermediary is its stock of historic relationships, it has fairly limited capacity, at least at this juncture, to foster impersonal relations.

A second type of organizational innovation that we observed is the financial-industrial group (FIG). Although only one of the firms we visited was a member of a registered FIG, nearly half of the firms were members

³⁴In three firms, the supply officials answered 90 percent, 80 percent, and 50 percent when asked what proportion of their suppliers were new to them since 1992. However, when the question was rephrased to elicit what proportion of supplies came from producers that were new to them since 1992, the answer in all three cases was zero percent.

³⁵See Brown et al. (1994) and Ickes, Ryterman, and Tenen (1995).

of informal, unregistered FIGs. While the motivation for these groups is multifaceted, one purpose appears to be the need to solve problems of contract enforcement, given that many FIGs include firms in the same trading network.

Space constraints prohibit an extensive discussion of the implications of the observations presented above. We simply end with two examples. Because of the lack of institutional support providing adequate security in contracting, there is a danger that many potential transactions will not be realized, with adverse consequences for economic recovery. In fact, we found little evidence that enterprises are buying or selling sophisticated, complex goods. Typically, agreements for transactions in such goods extend over a lengthy period of time, requiring the use of an array of instruments to minimize the risk of the transaction for the parties involved. Despite our efforts to identify such transactions, we were unable to do so. For example, firms report that there is a rather short time between agreement and shipment of the goods they purchase and sell. Moreover, none of the agreements we studied required any special investment by the seller and only one required special investment by the purchaser.

Secondly, the absence of institutions to support impersonal relations is likely to impede the entry of new firms, which cannot initially take advantage of relational contracting based on past ties. This is particularly troublesome in view of the importance of new firms to long-run growth in the economy. Perhaps even more worrisome is the fact that many of the firms that do enter will be forced to rely on the mafia and other private security firms for contract enforcement, suggesting the possibility of greater entrenchment of the mafia in economic and social life in Russia in the future.

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